THE INDONESIAN JOURNAL OF BUSINESS ADMINISTRATION
Vol. 2, No. 9, 2013:1043-1047

BUSINESS STRATEGY FOR COMPANY XYZ DEALING WITH DOMESTIC CONTENT REQUIREMENT IN INDONESIA OIL AND GAS INDUSTRY

Arif Budiman Syamra and Agung Wicaksono
School of Business and Management
Institut Teknologi Bandung - Indonesia
arif.budiman@sbm-itb.ac.id

Background

The 2nd revision of PTK (Peraturan Tata Kerja) No. 007 by BP Migas (Indonesia Oil and Gas Regulatory Body, now called SKP Migas) contains a very strong Nationalization spirit to encourage domestic products and services leveraged. This revision, as stipulated in tender bid documents, requires a comprehensive local content achievement by Contractors, where bidders must meet at least minimum 35% of total products and services offered in their bid proposal are coming from domestic products and services. To some extent of tender scopes, only 2 or 3 international companies only that technically qualified for the works, however these international companies couldn't achieved this 35% domestic content requirement, while in the other hand, all existing national companies and have better percentage of domestic content utilization, are technically incompetence to perform the requested works.

Direct impacts of this situation are:

1. Poor tender time management
2. Delayed to project commencement

Further impacts could lead to:

1. Penalty charges due other project being hold waiting
2. Investor may suspend investment plan, or could worst to cancelation

Michael Porter's model

There is a strong relation between Porter's diamond model with this final project case, it is the competitive advantage owned by international company that will keep them stay in game. Porter's diamond model suggests that there are inherent reasons why some nations, and industries within nations, are more competitive than others on a global scale. The argument is that the national home base of an organization provides organizations with specific factors, which will potentially create competitive advantages on a global scale. (http://www.businessmate.org/Article.php?ArtikelId=49)

Porter's model includes 4 determinants of national advantage, which are shortly described below:

1. Factor Conditions, are conditions that can be exploited by companies in a given nation, can be seen as advantageous factors found within a country, as a factor potentially strengthening competitiveness, as heighten companies' focus on automation and zero defects.
2. Demand conditions, if the local market for a product is larger and more demanding at home than in foreign markets, local firms potentially put more emphasis on improvements than foreign companies. This will potentially increase the global competitiveness of local exporting companies. A more demanding home market can thus be seen as a driver of growth, innovation and quality improvements.
3. Related and Supporting Industries, when local supporting industries and suppliers are competitive, home country companies will potentially get more cost efficient and receive more innovative parts and products. This will potentially lead to greater competitiveness for national firms. This is also the benefit that has strengthening US firms worldwide due a highly competent pool of related business and industries in US.

4. Firm Strategy, Structure, and Rivalry, The structure and management systems of firms in different countries can potentially affect competitiveness. US firms are oftentimes very hierarchical, which has resulted in advantages within industries such as engineering.

Entry Strategy in International Business

There are six different ways to enter a foreign market:

1. Exporting, the attractiveness lies in the ability to avoid the costs of establishing local manufacturing operations, and helping the firm achieve experience curve and location economies. It will be less attractive because of there may be lower-cost manufacturing locations, with higher transport costs and tariffs can make it uneconomical, and the condition that agents in a foreign country may not act in exporter's best interest
2. Turnkey projects, the contractor handles every detail of the project for a foreign client, including the training of operating personnel, and the foreign client is handed the "key" to a plant that is ready for full operation. It is attractive due it provides a way of earning economic returns from the know-how required to assemble and run a technologically complex process, and less risky than conventional FDI. Unattractiveness exist due the firm has no long-term interest, and it may create a competitor, and if the firm's process technology is a source of competitive advantage, then selling it through a turnkey project is also selling competitive advantage to potential and/or actual competitors
3. Licensing, a licensor grants the rights of intangible property (IP) to the licensee for a specified time period, and in return, receives a royalty fee, patents, inventions, formulas, processes, designs, copyrights, trademarks. The attractiveness lies the ability to avoid development costs and risks associated with opening a foreign market, and avoid barriers to investment, yet the ability to capitalize on market opportunities without developing those applications itself. It will be less attractive as the firm doesn't have the tight control required for realizing experience curve and location economies, limited ability to coordinate strategic moves, potential loss of proprietary (or intangible) assets, but to reduce this risk, firms can use cross-licensing agreements
4. Franchising, a specialized form of licensing in which the franchisor not only sells IP to the franchisee, but also insists that the franchisee agree to abide by strict rules as to how it does business; it is used primarily by service firms. It is attractive because it can avoid the costs and risks of opening up a foreign market, and the ability for firm to quickly build a global presence. Franchising can be unattractive due it inhibits the firm's ability to take profits out of one country to support competitive attacks in another, and the geographic distance of the firm from franchisees can make it difficult to detect poor quality
5. Joint ventures (JVs) with a host country firm, a firm that is jointly owned by two or more otherwise independent firms. JVs are attractive because it produce benefit from a local partner's knowledge of local culture, political systems, and business systems, while the costs and risks of opening a foreign market are shared, and satisfy political considerations for market entry. Reason for unattractive JVs due risks of giving out control of its technology, and may not have the tight control to realize experience curve or location economies, also the shared ownership can lead to conflicts and battles for control if goals and objectives differ or change.
6. Wholly owned subsidiary, the firm owns 100 percent of the stock; it can be done by setting up a new operation (Greenfield venture), and acquiring an established firm (M&A). This is attractive because it reduces the risk of losing control over core competencies, gives a firm the tight control over operations in different countries that is necessary for engaging in global strategic coordination, and may be required in order to realize location and experience curve economies. It will be less attractive because the firm bears the full cost and risk of setting up overseas operations.

Some key factors for the success of an alliance:

1. Partner selection, the expected criteria will be helping the firm achieve its strategic goals and has the capabilities the firm lacks and that it values, to shares the firm's vision for the purpose of the alliance, and will not exploit the alliance for its own ends

2. Alliance structure, needs to have proper barrier for any unintended transfer of technology, have contractual safeguards to guard against the risk of opportunism, allow for skills and technology swaps with equitable gains, and the ability to minimize the risk of opportunism
3. Managing the alliance, will require interpersonal relationships between managers, learning from alliance partners

   The three major types of strategic alliances classified by their ownership arrangements, include
   a. Joint Venture, a strategic alliance in which two or more firms create a legally independent company to share some of their resources and capabilities to develop a competitive advantage. Joint ventures, which are often formed to improve firm's ability to compete in uncertain competitive environments, are effective in establishing long-term relationships and in transferring tacit knowledge. Because it can't be codified, tacit knowledge is learned through experiences such as those taking place when people from partner firms work together in a joint venture, tacit knowledge is an important source of competitive advantage for many firms.
   b. Equity Strategic Alliance, an alliance in which two or more firms own different percentages of the company they have formed by combining some of their resources and capabilities to create a competitive advantage.
   c. Non-Equity Strategic Alliance, an alliance in which two or more firms develop a contractual relationship to share some of their unique resources and capabilities to create a competitive advantage. In this type of alliance, firms do not establish a separate independent company and therefore do not take equity positions. For this reason, non-equity strategic alliances are less formal and demand fewer partner commitments than do joint ventures and equity strategic alliances, though research evidence indicates that they create value for the firms involved.

Instrument of International Trade Policy

There are seven instruments associated across country trade policies

1. Tariffs, is a tax levied on imports (or exports), mostly placed on imports to protect domestic producers from foreign competition by raising the price of imported goods. Two categories:
   a. Specific Tariffs are levied as affixed charge for each unit of a good imported (for example $3 per barrel of oil)
   b. Ad valorem tariffs are levied as a proportion of the value of the imported good

   Economic analysis about effect of import tariffs:
   - Tariffs are unambiguously pro-producer and anti-consumer
   - Reduce the overall efficiency of the world economy

   Effect of export tariffs:
   - Raise revenue of government
   - Reduce export from a sector, often for political reasons
2. Subsidies, is a government payment to a domestic producer, tendency given to agriculture and could be in form of cash grants, low-interest loans, tax breaks, and government equity participation in domestic firms. By lowering production costs, subsidies help domestic producers in two areas: Competing against foreign imports and gaining export market
3. Import quotas, is a direct restriction on the quantity of some good that may be imported into a country, enforced by issuing import license to a group of individuals or firms
4. Voluntary export restraints, is a quota on trade imposed by the exporting country, typically at the request of the importing country's government
5. Local Content Requirement, is a requirement that some specific fraction of a good be produced domestically, and it could be in physical terms or in value terms. It provides protection for a domestic producer of parts in the same way an import quota does, by limiting foreign competition
6. Administrative Policies, are bureaucratic rules designed to make it difficult for imports to enter a country

7. Antidumping duties, are designed to punish foreign firms that engage in dumping, the ultimate objective is to protect domestic producers from unfair foreign competition.

Analysis

After having thoroughly examined all the entry mode options, some qualitative criteria showed up, there are:

1. Marketing approach: this criteria act as backbone for business development in the future, excellency in this area is very important once organization established.
2. Tendering process: considering complexity of bidding and contractual process in Indonesia Oil and Gas sector, this quality is critical as a passing grade to determine will a business firm can participate in a tender process
3. Impact related regulation: status of one's business firm entry mode will determine the rest of process that related to regulation
4. Cost of operation: for an international company dcoming and investing in Indonesia, financial benefit is one of basic criteria whether it will be feasible or not
5. Cost of action: is a parameter to determine how much capital required to do the entry mode option, will the cost incurred justify the business expectation.
6. Chance for implementation: although sounds more to subjective, but this criteria is a gate to go to the other criteria, no matter how good one criteria justify the purpose, without having a good chance for implementation, it will not going anywhere.

From all of those entry mode options, although Acquisition seems giving the most attractive solution for international company, but the chance for its implementation in Indonesia is very low, therefore is not a do-able option.

The option then goes to Joint Venture (Strategic Alliances), that this is the best possible criteria in this scenario, it will help solve the domestic content requirement by regulation, as it will be considered as National Company, and will maintain economic cost to the business.

Summary

Government of Indonesia through BP Migas put a serious concerns on how to leverage domestic content in oil and gas industry, by establishing PTK No.007 Rev.2, this concern is adopted and implementation is enforced, the intention is that Indonesia will get as much more as applicable the benefit of foreign investment, benefit of technology sharing, development of new manufactures in country and so on.

PT. XYZ is exist in Indonesia for more than 30 years, and so far has extensive operation in drilling both exploration and development blocks under two modes of entry, one as Joint Venture, and the other under New Wholly Subsidiary.

The composition of the sharing one and the new wholly subsidiary have domestic content calculation below what required by PTK No.007 Rev.2, that becoming issue in the tendering process, as specific expertise of PT. XYZ is played only by very limited providers, that up to today only 2 others with equivalent capabilities and expertise, and interestingly nor those 2 others providers will meet the domestic content requirement.

As wise people said, there's good opportunity in every bad difficult situation, this one should also provide opportunity for local professional people to take greater roles, to participate in the nation development, support the domestic content spirit, while making money at the same time, and help to provide solution to all parties.

Recommendations

With all the business strategy concepts and entry modes options, and upon writer experiences, here are recommendation that can help all parties resolved this situation:

1. Entry mode of all PT. XYZ entities need to be escalated to Joint Venture type, by this, PT. XYZ will earn:

   a. Increased local content calculation to goods and services measured
   b. Privileges of being national company, such tax reduction
2. Establish manufacturing facility in Indonesia, that this country is having positive economic growth recently and showing improvement over the year, this plan will give benefits to PT. XYZ for:
   a. Significant increase to local content calculation to goods and services measured
   b. Indonesia cost of operation is lower than Singapore and Malaysia as current manufacturing facility, with understanding and optimism the current political and economic situation is going positive stability.

However, finding the right local partnership is another big challenge, consideration should be with qualification below:
1. Understanding of all respective regulations in the oil and gas industry in Indonesia
2. A partnership firm should be established by collection of multitasking experienced people in Indonesia oil and gas tendering process based on PTK No.007 Revision 2
3. Strong relationship and access to higher government level
4. Understanding of FCPA regulation related financial report systems, and works within its guidance.

What is required from partner

The essence of partnership needs is to combine the strength points to anticipate each other weakness, that give more opportunity in business and turn threats into another new opportunity.
Further what required by International Company from partnership with local firm related to expectation of PTK No. 007 Rev.2 are:
1. Sharing Investment Capital to accommodate the local content limitation in the host country Indonesia
2. Supports to get extra benefit in customs process, and all related paperwork related international investment, so the investment could expand to have local manufacturing also in the host country Indonesia, by having this, no more barrier for International Companies to compete in Indonesia which may arise from Local Content issue.

References

1. Ireland, R., Duane & Hoskisson, Robert, E., & Hitt, Michael A., South Western., The Management of Strategy, Concepts and Cases., 9th Edition., 2011
2. Hill, Charles W.L., International Business, Competing in the Global Marketplace., 8th edition., 2011
3. August Ray & Mayer Don & Michael Bixby., Pearson International., International Business Law, Text Cases,and Readings., 5th Edition., 2009